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BUREAU OF COMPETITION

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

March 2, 1990

The Honorable Alan A. Diamonstein
Chairman
General Laws Committee
House of Delegates
Commonwealth of Virginia
Richmond, Virginia

COMMISSION AUTHORIZED

Dear Chairman Diamonstein:

The staff of the Federal Trade Commission[1] is pleased to submit this letter in response to your request for comments on the potential competitive effects of Senate Bill 235, a proposed "divorcement" law that would prohibit petroleum refiners from (1) owning and operating retail motor fuel stations; (2) requiring certain hours of operation by their franchised or leased retail stations;[2] and (3) enforcing branded product purchase and resale requirements. We believe that, if enacted, S.B. 235 may lessen competition among motor fuel dealers and raise gasoline and diesel prices to Virginia consumers and visitors.

Interest and experience of the Staff of the Commission

The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive practices in or affecting commerce. 15 U.S.C. § 45. Under this statutory mandate, the Commission seeks to identify restrictions that impede competition without offering countervailing benefits to consumers. In particular, the Commission and its staff have had considerable experience assessing the competitive impact of regulations and business practices in the oil industry.[3]

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1 These Comments are the views of the staff of the Bureau of Competition of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner. Questions about these comments may be addressed to Ronald B. Rowe, Director for Litigation, Bureau of Competition, 600 Pennsylvania Avenue, N.W., Washington, D.C. 20580. Mr. Rowe's telephone number is (202) 326-2610.

2 Hereafter, retail motor fuel dealers selling branded gasoline supplied by the major petroleum refiners pursuant to leased or franchised station contractual arrangements, will be referred to as "lessee-dealers."

3 The staff of the Commission has gained extensive experience with energy competition issues by conducting studies, investigations, and law enforcement actions. Staff comments and testimony to legislative bodies have identified the costs of

(continued...)

Description of S.B. 235

S.B. 235 would amend and reenact Section 59.1-21 of the Code of Virginia, the Virginia Petroleum Products Franchise Act, which, among other things, prohibits refiners from owning and operating new stations within a mile and a half from lessee-dealer stations. [Section 1] Our principal concern is with the provision of S.B. 235 that would prohibit refiners from operating new retail motor fuel stations with company personnel or from leasing such stations to persons on a fee arrangement basis, after January 1, 1991.[4] [Section 59.1-21.16:2].

We are also concerned with those provisions of S.B. 235 that would interfere with gasoline station franchise contracts to redress alleged unfair practices by major refiners.[5] As discussed below, to the extent that these provisions conflict with a refiner's national franchising program, the refiner may be hampered from competing effectively in Virginia. Section 59.1-21.11 would prohibit refiners from requiring their lessee-dealers to (1) stay open for business for more than 16 hours per day or for more than 6 days per week; (2) participate financially in refiner-sponsored discounts or premiums to consumers at their stations; (3) limit the number of retail outlets that individual lessee-dealers may operate for the same refiner; and (4) adhere to working hours established by the refiner. This section would also enact "open supply" for lessee-dealers by allowing them to purchase and sell brands of motor fuels other than those of their lessors. [Id.]

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[3](...continued) proposed gasoline retailing divorcement, "below-cost selling," and other petroleum market legislation in North Carolina, South Carolina, Georgia, Alabama, Tennessee, Washington, Hawaii, Nevada, and for the United States Senate and House of Representatives. The Commission and its staff have also gained considerable experience with gasoline refining and marketing issues affecting consumers from premerger antitrust reviews pursuant to Sections 7 and 7A of the Clayton Act, 15 U.S.C. §§ 18, 18a.

[4] An amendment recently adopted by the Senate Committee marking up the bill exempted refiner-owned and operated locations existing as of December 31, 1989, from the law's divorcement requirements.

[5] Compared with S.B. 235, the present Virginia Petroleum Products Franchise Act, supra, only modestly limits refiner flexibility.

Section 59.1-21.11 of S.B. 235 would require refiners to establish "reasonable and uniform" standards for refiner disapproval of franchise transfers or sales by dealers and require written notice of any disapproval. That section would also require that all initial agreements between refiners and dealers have at least a one year term and that all subsequent agreements be at least three years long. The rental provisions in such agreements or franchises are to be "objectively fair and reasonable and . . . based on commercially reasonable standards, uniformly applied to all similarly situated dealers." [Id.] At the death, disability, or retirement of the dealer, the franchise rights would be passed to a designated family member who has been previously approved according to "reasonable and uniform standards." [Id.]

The Bill would also require refiners to justify credit card fees to dealers and to provide audited annual financial statements that would itemize and explain all credit card costs. [Id.]

No reliable evidence supports claims of a need for laws to alter motor fuel franchise contracts

Proponents of "divorcement"[6] and "open supply" legislation have maintained that such laws are necessary to protect the franchised dealers of major, integrated refiners from unfair and anticompetitive practices by their suppliers. They argue that permitting refiners to own and operate retail gas stations in competition with independent dealers and franchised dealerships of major branded suppliers is unfair. According to this view, the refiners can and do "subsidize" their own retail operations by providing gasoline to those outlets at prices that are both below cost and below the wholesale prices charged to lessee dealers. Refiners' alleged reason for such "subsidization" is to drive their own lessee-dealers out of business in order to replace them with company-owned and operated stations.

The claims that vertical integration by refiners into gasoline retailing is anticompetitive in and of itself or because of refiner subsidization do not appear to be well founded. In fact, although most refiners in the United States are vertically integrated into gasoline retailing because such integration is

[6] "Divorcement" laws, or existing or proposed laws that call for refiner divestiture of retail gasoline stations, refer to legislation to eliminate or lessen vertical integration between petroleum refining and retail marketing sectors of the petroleum industry.

efficient, the "major"[7] oil companies targeted by this bill are the least integrated into retailing. Major oil companies have historically been "integrated by contract," relying heavily on franchised dealer networks to sell their refined products. The following studies of competition in gasoline marketing in the United States since 1981 have concluded that gasoline dealers have not been and are not likely to become targets of anticompetitive practices by their suppliers. We briefly summarize the results of these studies below.

Federal Studies - Following enactment of Title III of the Petroleum Marketing Practices Act ("PMPA") in 1978, 15 U.S.C. § 2841, the Department of Energy ("DOE") studied whether the alleged "subsidization" of retail gasoline operations by the major refiners actually existed, and, if it did, whether the practice was predatory or anticompetitive. The final report to Congress, published in January of 1981, was based on an extensive study of 1978 pricing data in several Standard Metropolitan Statistical Areas ("SMSAs"), as well as on internal oil company documents subpoenaed by DOE investigators. The study concluded that there was no evidence of such "subsidization."[8]

In 1984, DOE published an updated study that further substantiated and elaborated on its 1981 findings.[9] The study showed that company-operated stations were not increasing as a percentage of all retail outlets, except among the smaller refiners. In the 1984 report, DOE concluded that the increased pressures on gasoline retailers since 1981 were not caused by anticompetitive behavior on the part of the major oil companies. Rather, the decline in the overall number of retail outlets and the intensification of competition among gasoline marketers were attributable to decreased consumer demand for gasoline and a

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[7] "Major" oil companies describe a group consisting generally of the largest fully integrated petroleum firms that, in the aggregate, have the largest shares of most levels of petroleum production, refining, distribution, and marketing. These companies include Exxon, Chevron, Mobil, Texaco, Amoco, Sohio, Shell, and other well-known firms.

[8] DOE, Final Report: The State of Competition in Gasoline Marketing, 1981.

[9] DOE, Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers, March, 1984 (hereinafter cited as 1984 DOE Report).

continuing trend toward the use of more efficient, high-volume retail outlets.[10]

<u>State Studies</u> - In 1986, the Washington state attorney general initiated a study of motor fuel pricing in that state to determine whether claims of refiner-subsidization were justified. The study focused on whether major oil companies injured competition by charging lessee-dealers higher prices for gasoline than the companies were charging their own company-operated retail stations. The study also sought to examine whether the major oil companies injured competition by establishing a pricing structure between retail and wholesale prices that foreclosed the ability of dealers to cover their costs. Information was gathered on the practices of all eight of the major companies in Washington for a three-year sample period. The study covered regions throughout the state where the companies maintained both retail operations and lessee-dealer operations. The Final Report found that less than one percent of all observed pairs of prices of lessee dealers and company-operated stations disclosed any significant price variations, and concluded that such instances were "clearly too infrequent" to show that lessee dealers were being systematically driven from the market because their gasoline purchase costs were the same or higher than the retail prices of competing refiner-operated stations.[11]

More recently, an Arizona legislature special committee conducted an extensive inquiry and concluded that special lesgislation similar to that proposed in Virginia was not justified. In December of 1988, that investigative body recommended that no new legislation be enacted, concluding that "[t]he marketplace for petroleum products is very competitive in Arizona."[12]

The state and DOE studies have revealed no instances of predatory behavior on the part of major gasoline refiners; rather, they show that the fortunes of refiners and their franchised retailers are closely linked, and that they "form a mutually supporting system backed by company advertising and

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[10] <u>Id</u>. at 125-32.

[11] Final Report to the Washington State Legislature on the Attorney General's Investigation of Retail Gasoline Marketing, August 12, 1987, at 14.

[12] Final Report to the Arizona Joint Legislative Study Committee on Petroleum Pricing and Marketing Practices and Producer Retail Divorcement, December, 1988, at 35.

promotion."[13] Independent franchised retailers have continued to be by far the predominant form of outlet for the direct gasoline sales of major, integrated refiners, who operate only a small percentage of the gasoline stations in the United States.[14]

Given their continuing massive investment in branded, lessee-dealer marketing distribution systems, major refiners are unlikely to charge their lessee-dealers prices that would cause them either to seek new sources of supply or to go out of business. A refiner that undertook such a course of action would probably face a decrease in market share, an increase in unused refining capacity, and higher per unit costs. Put another way, the major integrated refiners are not likely to engage in predation against themselves.

The impact of S.B. 235 on small refiners

Furthermore, although S.B. 235 is intended to remedy the alleged unfair activities of major, integrated refiners, the legislation may affect them less severely than it would smaller refiners who may want to compete for new locations for retail stations. Only a minor percentage of the major refiners' branded outlets in Virginia are owned and operated by the major refiners themselves;[15] those sites are exempted from the requirements of

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[13] 1984 DOE Report, supra, at ii. (Although the information for this proposition comes from 1984 and earlier materials, we have no reason to believe that the distribution structure has significantly changed since that time; gasoline and diesel fuel production and distribution methodologies have remained the same.)

[14] In 1981, the eight largest refiners, who in the aggregate, accounted for about half of all gasoline sales, sold approximately eight times more gasoline through lessee dealers than through company-operated outlets. Id. at 146 (Table A-10). The 1984 DOE Report confirmed a similarly low proportion. So did the Lundberg Letter, Vol. XI, No. 36, July 6, 1984, at 3. A recent study contracted for by the American Petroleum Institute ("API") noted that the 14 largest integrated refiners, representing approximately 67% of the nation's refining capacity, had only about 10% of their gross gasoline sales and 4.5% of their outlets devoted to salary-operated retail stations. Temple, Barker & Sloan, Gasoline Marketing in the 1980s: Structure, Practices, and Public Policy at 2-3 (1988).

[15] According to the National Petroleum News ("NPN") 1989 Factbook, at 34-51, the leading branded refiners in Virginia have (continued...)

the proposed bill. In contrast, the majority of smaller, independent refiners' outlets are company owned and operated.[16] This suggests that smaller, independent refiners find that company operated outlets are more efficient than lessee-dealer outlets. Consequently, refiner-marketing divorcement in Virginia, which would adversely affect all refiners, would be most harmful to smaller, independent ones.

Monopolistic and predatory behavior is presently covered by state and federal antitrust laws; new legislation to regulate gasoline markets is unnecessary

Predatory or monopolistic behavior, including "predatory subsidization" in the petroleum industry, is subject to the Sherman Act, the Clayton Act, and the Federal Trade Commission Act. The Virginia Antitrust Act similarly prohibits monopolistic behavior [Section 59.1-9.1 et seq. of the Virginia Code]. These statutes address possible anticompetitive practices in the industry more effectively than would legislation restricting new entry by potential competitors and regulating contractual relationships between suppliers and purchasers of gasoline.

The existing antitrust laws deter firms from engaging in monopolistic behavior, but, at the same time, allow them to lower their costs of operation through their gasoline distribution systems. Manufacturers selling in multi-regional, national, or broader markets typically impose standardized distribution requirements across markets to insure that customers will be able to receive the same product no matter where they shop. Lessee-dealer contract requirements imposed by refiners similarly reflect branded refiners' competitive strategies. Traditionally, such strategies have emphasized service and other non-price forms of competition. Unbranded marketers, by way of contrast, have competed solely on a price basis, and they are usually refiner-

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[15](...continued) the following percentages of their overall branded outlets nationally in company operations: Exxon (5.2%); Texaco (5.7%); Chevron (5.5%); Amoco (2.4%); Unocal (1.3%); Shell (2.6%); BP (14%); Mobil (6.5%).

[16] Id., disclosing that 86% of Crown Central Petroleum Corp.'s outlets appear to be company operated. In 1985, Crown opposed federal divorcement legislation (S. 1140), noting that it would "threaten the survival of our limited presence in . . . Virginia, the Carolinas, Georgia, Florida and Alabama. . ."[Motor Fuel Sales Competition Improvement Act of 1985: Hearings on S. 1140 Before the Senate Committee on the Judiciary, 99th Cong., 1st Sess. 306 (1985)("S. 1140 Hearing"); emphasis added].

owned and operated. S.B. 235 would therefore restrict the ability of firms to realize increased market efficiencies and to adjust to changing market conditions. Because both types of marketing provide price and service options for consumers, competition and consumers would be harmed by legislation restricting entry and expansion.[17]

S.B. 235 is likely to result in higher motor fuel prices

The present Virginia law limits competition between refiner operated stations and lessee-dealers of the same brand, but permits refiner operated retail stations that are no closer than one and one half miles from refiners' franchised dealer stations. The present law places Virginia among only a few states that limit refiner retail motor fuel operations, but reflects compromise legislation that may preserve whatever cost savings may be associated with vertical integration between the refinery and retail distribution levels of the industry. In competitive markets, such savings are usually passed on to consumers in the form of price competition. The proposed Virginia divorcement provision would deny consumers additional opportunities for lower prices attributable to affiliated refining/marketing operations of smaller refiners.

Because "low" prices typically benefit consumers, calls for their abolition should be viewed with skepticism, especially in the absence of reliable evidence of illegal behavior. Legislation such as S.B. 235 is likely to add costs to the distribution of gasoline in Virginia that do not exist in other states, costs that would be passed on to Virginia consumers and visitors. The potential harm of divorcement and other regulatory legislation may be illustrated by the experience of the State of Maryland, which in the early 1970s enacted divorcement legislation similar to that now proposed by S.B. 235. One economic study, described by DOE as perhaps "the best empirical analysis of the effects of Maryland's divorcement law,"[18] estimates that Maryland consumers may be paying millions of dollars more per year for gasoline primarily because of that law.[19]

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[17] See Temple, Barker & Sloan, supra at 23-54.

[18] 1984 DOE Report, supra, at 105, describing a study by Barron and Umbeck.

[19] See Barron and Umbeck, A Dubious Bill of Divorcement, Regulation, Jan.-Feb., 1983, at 29. See also Hearings on S. 326, Before the Senate Comm. on the Judiciary, 97th Cong., 1st Sess.
(continued...)

A study commissioned by the Maryland State Comptroller's Office and the state attorney general to defend the divorcement law against a legislative proposal for its repeal concluded that the law benefitted consumers, saving them nearly $117 million.[20] The study, however, contained serious flaws that undermined its conclusion. It compared average prices for full and self service gasoline in Baltimore to average prices in six cities outside Maryland during a four year period. Such comparisons of average prices in different areas, however, fail to take adequate account of any differences in the proportions of full and self service gasoline purchased in those areas. Thus, if the purchase of high price, full service gasoline in Baltimore constituted a smaller percentage of total gasoline than in other areas, the average price of gasoline might well appear to be less in Baltimore. However, more consumers in Baltimore would be choosing a lower quality product and service mix, with an attendant lower price, than that chosen by consumers in other areas.

In fact, the data indicate that an unusually small proportion of purchases in Baltimore is full service gasoline sales, perhaps because the price differential in Baltimore between full and self service gasoline is unusually large.[21] For this reason, the $117 million figure calculated in the study does not represent consumer savings associated with the purchase of a

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[19](...continued)
(Oct. 21, 1981)(Testimony of Pester Corp. and Crown Central Petroleum Corp.); Barron and Umbeck, The Effects of Different Contractual Arrangements: The Case of Retail Gasoline Markets, 27 J. Law & Econ. 313 (1984). See also n. 16, supra, S. 1140 Hearing at 305-306, where Crown stated that "retail divorcement in Maryland has been a disaster for both small and independent refiners and others who do not have the brand recognition or the benefit of millions of credit card holders that the major refiners have." Crown complained that, because of divorcement, it lost over 25% of its market share between 1979 (when divorcement became effective) and 1984. Id.

[20] See Putnam, Hayes & Bartlett, Gasoline Prices in Maryland Following Divorcement (1987).

[21] During the period examined in the study, the full service consumption rate in Baltimore ranged from 14 to 17 percent, the lowest rate of any northern city. Baltimore also had the highest premiums for full service over self service, approximately 33 cents per gallon for unleaded regular, of any northern city. See Lundberg Letter, Vols. XII, XIII, and XIV, "Price/Margin Report," 1985-1987.

comparable product and service combination. If and to the extent that divorcement is responsible for the unusually high full service price in Baltimore, divorcement may have diminished the variety of product, service, and price combinations and choices available for Maryland consumers and visitors.

The study also included southern cities in its comparison, but "full service" in southern cities typically is more extensive than full service in northern cities.[22] Therefore, even if the proportions of full and self serve gasoline purchases were the same in the two areas, a higher average price in a southern city may be associated with a higher quality product and service mix than that sold in Baltimore.

The Maryland study was also flawed in that it did not compare prices in Maryland before and after divorcement. One scholar made such a comparison and, using data that was otherwise the same, concluded that divorcement significantly increased Maryland gasoline prices.[23]

S.B. 235 may harm rather than help lessee-dealers

The provisions of S.B. 235 that would regulate the contractual relationships between refiners and their franchised retailers may be harmful not only to consumers, but also to retailers that favor such laws to the extent that the proposed legislation. weakens the branded marketing system of petroleum distribution. In response to such legislation, major refiners may abandon relatively efficient franchised retailer operations in favor of commodity sales of gasoline at the refinery gate or at wholesale terminals. Refiners may have less incentive to continue sizable investments in their lessee-dealer networks if they are unable to guarantee by contract that they will be able to sell their products and services through an efficient distribution system.[24]

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[22] See Sorenson, "The Cost To Consumers in Maryland of the Divorcement of Refiners from Retail Gasoline Marketing 1979-1986," Florida State University, January, 1988, at 11. In southern cities, full service typically includes checking tire pressure, washing windows and an under-the-hood inspection.

[23] Sorenson estimated that divorcement imposed an annual cost on Maryland consumers of between $32 million and $75 million. Id. at 20-21.

[24] See S. 1140 Hearing, supra n. 16, DOE testimony on similar legislation in the United States Senate, 256-273.

To the extent that S.B. 235 is intended to redress perceived gasoline retailer grievances against their refiner-suppliers, we suggest that you consider the extent to which these concerns have been addressed in existing federal legislation, the Petroleum Marketing Practices Act of 1978 ("PMPA"), 15 U.S.C. § 2841. The legislative history of the PMPA shows that Congress was concerned over similar allegations of abuses of the franchise relationship, and that the PMPA was intended to balance the rights of the respective parties to retail gasoline franchise agreements.[25]

Conclusion: The passage of S. B. 235 is not necessary in Virginia motor fuel distribution

For the reasons stated above, we believe that S.B. 235, if enacted, could injure commerce, competition, and consumers in Virginia. We believe that the bill would tend to insulate lessee-dealers from competition by potential entrants and by expansion of the existing refiner-operated networks. S.B. 235 could therefore cause higher motor fuel prices and fewer choices for Virginia consumers and visitors.

We appreciate the opportunity to comment on S.B. 235. Please feel free to call on us if we can be of further assistance.

Sincerely,

Ronald B. Rowe
Director for Litigation

[25] See Senate Report No. 95-731, 95th Cong., 2d Sess., 15-19, 29-43, reprinted in 1978 U.S. Code Cong. & Ad. News 873.